

PROFESSIONAL MILITARY COMPTROLLER SCHOOL

## IDEA PAPER

TITLE

**It's Time for DoD to Sack Its Price Stabilization Policy**

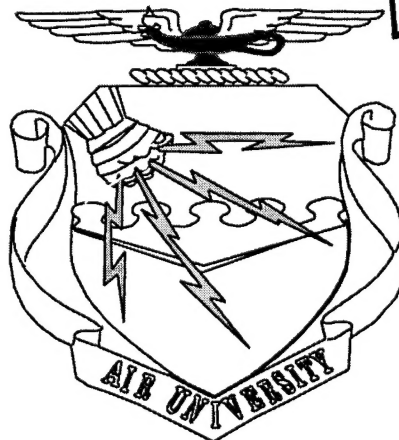
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DTIC QUALITY INSPECTED 8

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95C-56

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**TITLE:** IT'S TIME FOR DoD TO SACK ITS PRICE STABILIZATION POLICY

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### EXECUTIVE SUMMARY

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This paper recommends the Department of Defense (DoD) sack or at the very least, modify its current Price Stabilization Policy (PSP). The PSP has served DoD well and is still useful in simplifying budget estimates at all levels, which appears to be the main reason DoD hangs on to this dinosaur. However, this reason alone is no longer acceptable since DoD can now explain its budget inputs to Congress via the Defense Business Operations Fund (DBOF). This paper recommends DoD start using standard business operating procedures employed by Fortune 500 Companies and allow the standard price to adjust up or down throughout the fiscal year. The Service Components no longer need DoD to exercise a smoothing effect through its PSP; instead, DoD should see the demise of the PSP as a continuation of empowering the Services to manage their own budgets.

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## **INTRODUCTION**

What commercial businesses do you know which would consciously sell products over and over again at a loss and stay in business? Would never hold, or offer to hold a sale, not even for its "blue chip" customers; and has established policies amplifying the above procedures? Come on, I know you can think of at least one commercial company. None? Then why does DoD's wholesale Inventory Control Points (ICPs) hold steadfast to the above procedures? I submit that DoD's Price Stabilization Policy (PSP) is the cause of this dilemma. This paper investigates three inefficiencies caused by DoD's Price Stabilization Policy and will recommend corrective actions for each.

## **DISCUSSION**

### **INEFFICIENCIES CAUSED BY DOD'S PRICE STABILIZATION POLICY**

#### **PSP Encourages Higher Surcharges.**

According to DoD, PSP is a policy under which the standard price of each cataloged item shall remain constant throughout each fiscal year except for correction of error (1:9-16). This means that once a year ICPs establish prices for items they manage and are not allowed to change the prices during that year. Imagine each time a customer goes to a store to purchase an item, say a quart of oil, that the cost is always the same. Let's say \$1. Good deal? Not necessarily. If the price is what the customer expected, then \$1 is great. If the price is higher, say \$1.35, the customer may choose to shop around for a better deal. No one blames the customer for trying to get the best deal possible. In fact, it's encouraged. One would consider the customer a good steward of available resources, especially now, with the movement towards empowering employees

and limited funds. This is the beginning of the problem with the PSP. The ICP does not purchase an entire year's supply of oil in our example. Instead, the ICP may only purchase enough for the first three months based on past demand, limited dollars and policies. Subsequent oil buys by the ICP could mean a loss if the price is higher than \$1, say \$1.35, or a saving, if the price is lower than \$1, say \$0.85. If the price is \$0.85, the ICP is unable to adjust the \$1 price to pass the savings on to the customer. If the price is higher than a \$, the ICP losses money and must have a way to offset the loss. Herein enters the surcharge. A surcharge is an amount added to the latest acquisition cost or repair cost price on an item to arrive at the customer's standard or exchange price (1:9-17).

Because the ICP cannot change the price either up or down, surcharges tend to escalate to offset any unforeseen losses. In DoD's definition of the PSP, one could make changes to the price for error correction. Price changes like the ones identified are not considered errors. Contact with the Defense Logistics Service Center (DLSC), the coordinator of price changes for DoD, indicated price changes for stocked items seldom occur during a fiscal year. NOTE: This paper only addresses stocked items and keep the examples simple; however, the author is aware that non-stocked item prices are subject to price change more frequently.

Surcharges are sour notes to ICP customers, and the higher the surcharge the more the customer tries to buy around the ICP. Any time a customer can find a like item cheaper, it is likely that customer will want to purchase the item from that cheaper source. The ICPs could avoid the buy-around if they were allowed to adjust standard prices. To

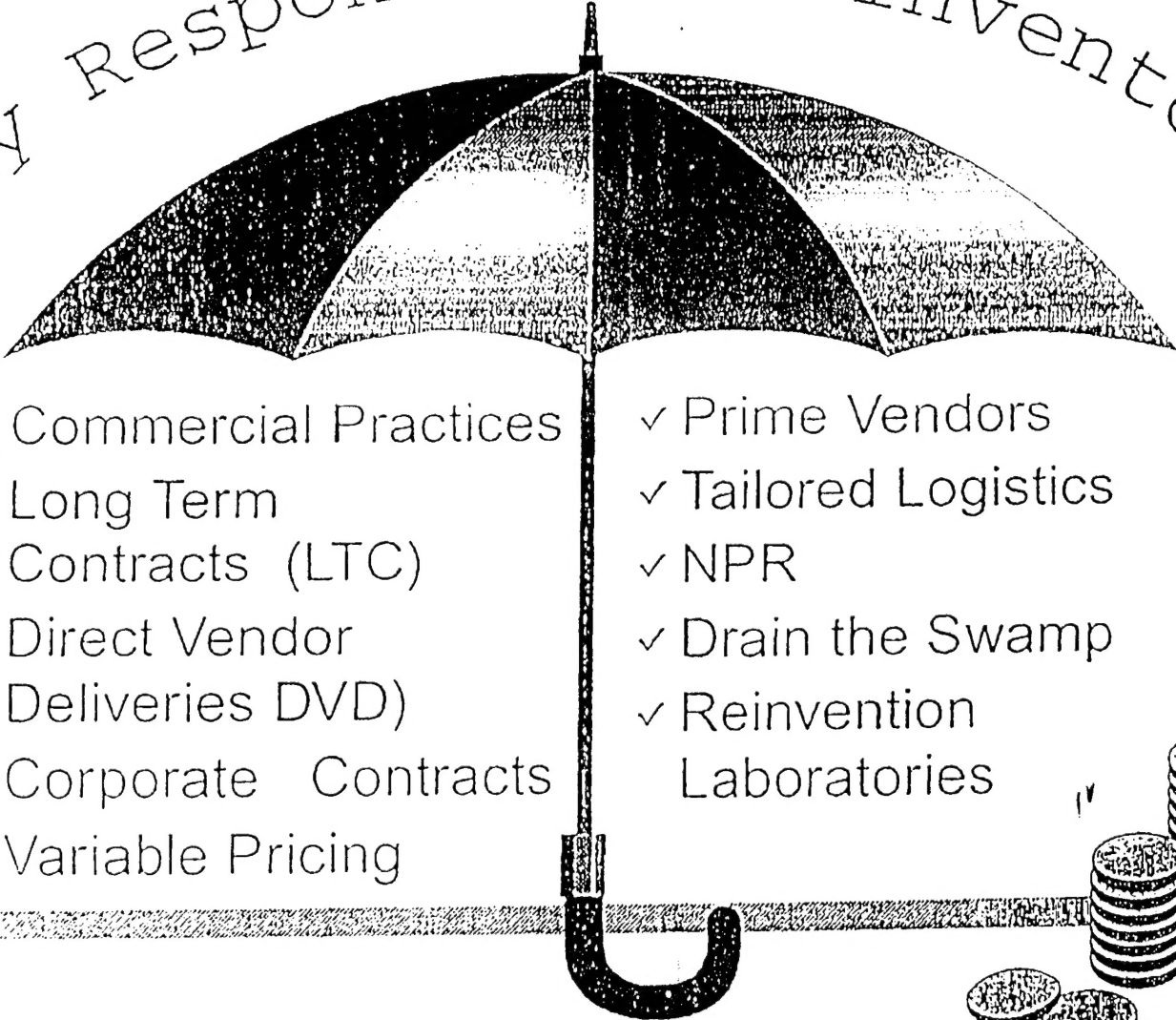
allow ICPs to adjust standard prices is to allow them to use acceptable standard business practices used by commercial companies to adjust price based on costs. The obvious recommendation for escalating surcharges is to allow ICPs to adjust the standard price when it makes good business sense. If the ICPs knew they could adjust the standard price, it would eliminate one reason to maintain the surcharges so high. Random checks of DoD's ICP surcharges revealed charges ranging from 10% to as high as 65% above the acquisition cost on some stock items. As one might expect, DoD's surcharges are not widely publicized. Let's turn now to a second problem with the DoD's Price Stabilization Policy, that of not allowing the ICPs to pass on savings to the customer.

**PSP Does Not Allow ICPs to Pass on Savings to the Customer.**

Many DoD initiatives are underway in response to Vice President Gore's National Performance Review. In the trenches at DoD's Inventory Control Points, especially Defense Logistics Agency ICPs, new innovative methods have appeared under the heading of Buy Response Vice Inventory (BRVI). See Table 1. BRVI is a concept with goals encouraging ICPs to work more closely with their customers and contractors to provide improved support. On the surface, actions are positive and show promise. However, a closer look raises some questions. For instance, attempts to establish Long Term Contracts (LTCs), Direct Vendor Deliveries (DVDs), and Variable Pricing (VP) initiatives to obtain better support, will clash head-on with DoD's Price Stabilization Policy. If ICPs were successful in obtaining reduced cost using DVDs, LTCs, and VP initiatives, they weren't able to pass on the savings to the customer because of the PSP and numerous system complications. Again, there are manual procedures to make price

# "BRVI"

## Buy Response Vice Inventory

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- ✓ Commercial Practices
  - ✓ Long Term Contracts (LTC)
  - ✓ Direct Vendor Deliveries (DVD)
  - ✓ Corporate Contracts
  - ✓ Variable Pricing
  - ✓ Prime Vendors
  - ✓ Tailored Logistics
  - ✓ NPR
  - ✓ Drain the Swamp
  - ✓ Reinvention Laboratories

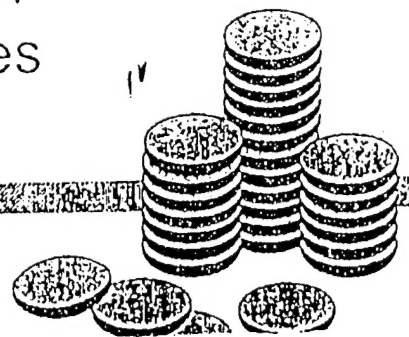


TABLE 1

changes, but changes were not established for these initiatives. Additionally, price changes are manpower intensive and involve manual changes in more than one logistics subsystem. Adjustments must occur in the requisition, contracting, and financial subsystems to ensure price changes. Few ICPs have the manning, initiative, time, and stick-to-it-iveness to track and monitor the price changes all the way through the various systems. This problem would not exist if DoD did not have a PSP. The recommendation to correct this problem is for DoD to repeal its PSP. This paper will now turn to the last inefficiency caused by PSP.

### **PSP Hides Real Costs.**

Within the last few years, DoD has sought ways to improve its methods to determine real costs. Unit Cost Resourcing (UCR) is currently getting the most attention. UCR is a methodology that relates the cost of all inputs (total costs) to output so that managers may determine resources required to produce all outputs (2:2) . It stands to reason that if costs were correct at the lowest levels, projections at higher levels would be more accurate, and when higher levels issue cost adjustment guidance, the lowest levels are able to react, relate and take appropriate actions. DoD's PSP does not work in harmony with UCR. Instead, the PSP promotes the opposite by hiding real costs. If managers did not use the PSP, they would use real costs to make budget inputs and submissions. Confidence and realism in the budget inputs would improve. Budget inputs starting with real cost data are better and more realistic. The annual prices set by the ICPs are not good indicators of real costs because prices fluctuate. DoD's PSP locks in



prices and disperses this information via DLSC to the lowest unit levels. The lowest unit level in turn uses these prices to submit budget inputs. It is clear from this scenario that the lowest inputs to the budget from the unit level using the PSP price is flawed. The recommended corrected action is to repeal the PSP.

### CONCLUSION

DoD used the PSP as means to simplify budget estimates. This idea worked well when there were no calculators, computers, laptops, or off-the-shelf software capable of performing accurate accounting cheaply and easily. It's time for DoD to reevaluate its PSP because it hides real costs at the lowest unit levels. This is confirmed when customers buy around the ICPs to obtain what they consider a better deal at a cheaper price. The PSP tends to smother the Services with bureaucratic overmanagement. Big Brother DoD assisting its Services because it knows better is actually hampering managers by preventing them from making good business decisions. This paper looked at three deficiencies associated with DoD's PSP policy: It ensures higher surcharges, does not allow ICPs to pass on savings to the customers, and hides real costs. In all fairness to DOD, one understands the desire to maintain the status quo, but the PSP is clashing head-on with many new and promising initiatives started by the ICPs to improve customer support. These were identified under the BRVI initiatives (LTCs, DVDs, and VP). There is little hope for these initiatives to succeed with the current PSP. Unless DoD changes the PSP, one might see the ICPs come up with a way to get around the policy.

When one thinks about it, the PSP clashes with Vice President Gore's National Performance Review initiative to reinvent government. PSP does not encourage management to become efficient; instead, it helps management hide real costs. It does not help managers to pinpoint waste; instead, it helps managers to keep in place a system that makes budget estimates easier, but is unrealistic.

Additionally, the PSP clashes with some of DoD's own new management ideas, such as UCR and DBOF. Both were aimed at improving management budget inputs and identifying real costs. PSP does nothing to promote these two initiatives. Finally, if the Services are going to be run like Fortune 500 businesses, some changes need to be made. This article has put the spotlight on DoD's PSP as one management tool that needs to be removed from the tool box. This paper will now make recommendations as to what new tools should replace the PSP.

### **RECOMMENDATIONS**

As indicated throughout this paper, DoD should repeal its Price Stabilization Policy. To begin this process, DoD should establish a reinvention laboratory at an ICP to test the merit of an ICP operation without the PSP. The test should allow the ICP to use current standard business practices to determine prices, and should last for at least one full budget cycle to see the full ramifications of budget inputs. DOD should include one operating unit from each Service to obtain accurate measurements of fluctuating prices and their budget inputs. Areas to closely watch are impact on surcharges, realism in pricing data, and feedback from participating units on buy-around actions. At the end of the test, DoD should assess results and make a final determination to continue to use the

PSP or to go to a more realistic system where the market place determines the price. This author believes DoD will repeal its Price Stabilization Policy after the test is completed.

## **LIST OF ABBREVIATIONS**

BRVI	Buy Response Vice Inventory
DBOF	Defense Business Operations Fund
DLSC	Defense Logistics Supply Center
DoD	Department of Defense
DVD	Direct Vendor Delivery
ICP	Inventory Control Point
LTC	Long Term Contract
PSP	Price Stabilization Policy
UCR	Unit Cost Resourcing
VP	Variable Pricing

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